

Private Letter Ruling: Petition granted for taxpayer to apply amendment to regulation Section 100.3380 retroactively.

December 3, 2009

Dear:

This is in response to your petition dated September 14, 2009 for use of an alternative apportionment method pursuant to Department Regulations Section 100.3390 (86 Ill. Adm. Code 100.3390). Department Regulations Section 100.3390(f)(1) states that after consideration of a petition for alternative apportionment, the Director shall issue a ruling letter advising the taxpayer whether the petition has been accepted, partially accepted, or rejected. For the reasons stated below, your petition has been accepted. COMPANY1 (“COMPANY1”), and members of its combined group may use the method of apportionment authorized in this ruling for the taxable year ending March 31, 2009. This ruling letter will bind the Department only with respect to the COMPANY1 combined group.

The facts and analysis as you have presented them are as follows (footnotes omitted):

Statement of Material Facts

COMPANY1 is wholly owned by COMPANY2 (“COMPANY2”), which, in turn, is wholly owned by COMPANY3 (“COMPANY3”), a publicly traded Japanese corporation, and, together with its subsidiaries and affiliates, manages COMPANY3’s United States operations from COMPANY1’s headquarters in Illinois. A leading pharmaceutical company, COMPANY4 researches, develops, markets, sells and distributes a variety of pharmaceutical products. COMPANY2 is the common parent of an affiliated group of corporations filing a federal (U.S.) consolidated income tax return.

For the taxable year ended March 31, 2009, COMPANY1 will file a combined Illinois corporation income and replacement tax return for its unitary business group. COMPANY1 and COMPANY5, Inc. (“COMPANY5”), a wholly owned subsidiary of COMPANY1, are among the companies that are included in the COMPANY1 unitary business group.

COMPANY1 and COMPANY5 each own an interest in COMPANY6 (“COMPANY6”), which is treated as a partnership for federal and Illinois income tax purposes. An unrelated third party owns the remaining interest in COMPANY6. COMPANY6 conducts its operations primarily within Illinois. COMPANY1 is the managing member of COMPANY6 and, for all practical purposes, exercises management control over COMPANY6. Accordingly, COMPANY1 considers COMPANY6 to be a member of its unitary business group.

COMPANY1 engages in the pharmaceutical business as the North American center for the marketing of COMPANY4’s products. Specifically, COMPANY1 purchases pharmaceutical products from COMPANY3, resells the products to COMPANY5 or COMPANY6 (depending on the particular product), performs overall strategic marketing, materials management and assembly, packaging, administrative services, and provides other functional support to entities in the COMPANY1 business group. COMPANY1 only conducts operations in Illinois.

COMPANY6 owns valuable intangible assets, including the development and marketing rights for certain pharmaceutical products. These rights were developed under a joint venture agreement, now dissolved, with the unrelated third party member of COMPANY6. COMPANY6

purchases from COMPANY1 those products for which COMPANY6 continues to hold the development and marketing rights. COMPANY6 resells those products to COMPANY5.

COMPANY5 sells and distributes pharmaceutical products purchased from COMPANY6 and COMPANY1. COMPANY5 conducts operations in many states.

For the taxable year ended March 31, 2009, COMPANY1 and COMPANY5 will, in aggregate, receive approximately 79 percent of COMPANY6's profits. This amount will be included in the COMPANY1 unitary business group's combined base income. The unrelated third party member of COMPANY6 will receive the remaining approximately 21 percent of COMPANY6's profits.

Ruling Requested and Analysis

COMPANY1 believes that, consistent with current 86 Ill. Adm. Code 100.3380(d)(2)(A), eliminating transactions between COMPANY6 and COMPANY1/COMPANY5 for purposes of computing the combined Illinois apportionment factor for the COMPANY1 unitary business group will more accurately reflect the group's business activity in Illinois for the taxable year ended March 31, 2009.

Section 304(e) of the Illinois Income Tax Act requires use of combined apportionment when two or more persons are engaged in a unitary business. The general methodology for use of combined apportionment in Illinois is included in 86 Ill. Adm. Code 100.5270(a). The regulation provides that, for a combined group, the unitary business group's combined business income is apportioned by using the total Illinois payroll, property, and sales of each member of the combined group and the total everywhere payroll, property and sales of each member of the unitary business group (including ineligible members). The regulation further provides that "[i]tems of income and deduction arising from transactions between members of the unitary business groups [sic] must be eliminated whenever necessary to avoid distortion of the denominators used by the unitary business group in calculating apportionment factors, or of the numerators used by the combined group or by ineligible members of the group in calculating apportionment factors." This regulatory guidance suggests that, as a general rule, the combined apportionment methodology requires transactions between members of a unitary business group to be eliminated for purposes of determining combined apportionment factor numerators and denominators.

However, 86 Ill. Adm. Code 100.3380 provides certain "exceptions" to the general apportionment rules. This regulation acts under the authority of Section 304(f)(4) of the Illinois Income Tax Act, the equitable apportionment statute, which provides the Department with the power, among other options and only "if reasonable," to employ "any other method to effectuate an equitable allocation and apportionment of the person's business income." One of the "exceptions" provided by 86 Ill. Adm. Code 100.3380(d) involves the "inclusion of shares of partnership unitary business income and factors in combined unitary business income and factors of partners."

Historically, the regulation provided that when the business activities of a partnership and the business activities of any partner constituted a unitary business, the "unitary partner" included its distributive share of the business income and apportionment factors of the partnership as

part of the partner's own business income and apportionment factors. In addition, the regulation historically specified that transactions between the unitary partner and the partnership were not eliminated for this purpose.

Effective June 30, 2008, the language of the regulation was amended. It now provides that, for purposes of computing the apportionment factors of a unitary partner and any other member of the unitary business group, "all transactions between the unitary business group and the partnership shall be eliminated."

Although the regulation was amended effective June 30, 2008, 86 Ill. Adm. Code 100.3380(a)(2) provides general transition rules, as follows:

For tax years beginning prior to the effective date of the rulemaking adopting a method apportioning business income, the Department will not require a taxpayer to adopt [an amended] method; provided however, if any taxpayer has used that method for any such tax year, the taxpayer must continue to use that method that tax year. Moreover, a taxpayer may file a petition under Section 100.3390 of this Part to use a method of apportionment prescribed in this Section for any open tax year beginning prior to the effective date of the rulemaking adopting that method, and such petition shall be granted in the absence of facts showing that such method will not fairly represent the extent of a person's business activity in Illinois.

Accordingly, COMPANY1 is respectfully submitting this PLR as a petition for alternative allocation or apportionment for its unitary business group taxable year ended March 31, 2009, which is a taxable year that began prior to June 30, 2008 (the effective date of the regulatory change described above). COMPANY1 requests that the transactions between COMPANY6 and its corporate partners (COMPANY1 and COMPANY5) be eliminated for purposes of computing the combined apportionment factor to be utilized by the COMPANY1 unitary business group. It also should be noted that the COMPANY1 unitary business group has not applied this methodology in any taxable year beginning prior to the effective date of the regulatory change.

For the year ended March 31, 2009, 79 percent, in aggregate, of the profits of COMPANY6 will be allocated to COMPANY1 and COMPANY5. Because COMPANY6, COMPANY1 and COMPANY5 are members of the same unitary business group, the apportionment factors of COMPANY6 will flow up to COMPANY1 and COMPANY5. However, the nature of COMPANY6's business requires that it purchase product from COMPANY1 and sell it to COMPANY5. Because both COMPANY6 and COMPANY1 primarily engage in business within Illinois, the failure to eliminate these transactions from the Illinois combined apportionment factor for the COMPANY1 unitary business group will distort the factor by approximately 285 percent. Distortion to this extent will occur because COMPANY1 sells to COMPANY6, after which COMPANY6 sells to COMPANY5 which then sells to unrelated third parties. Failing to eliminate these intercompany sales would thus triple count the unitary group's sales. The elimination of transactions between COMPANY6 and COMPANY1/COMPANY5 not only results in more accurate representation of the COMPANY1 unitary business group's Illinois business activity, but also is more consistent with the combined apportionment methodology provided by 86 Ill. Adm. Code 100.5270. Furthermore, as a policy matter, elimination of transactions between a partnership and its unitary corporate partner(s) reduces the risk of

apportionment factor manipulation. For example, if COMPANY6 and COMPANY1 primarily had engaged in business outside Illinois, the non-elimination of these transactions would have the exact opposite effect as that described above, resulting in a significant dilution of the Illinois combined apportionment factor.

Accordingly, we respectfully request that the Department allow the COMPANY1 unitary business group to adopt 86 Ill. Adm. Code 100.3380(d)(2)(A) prior to the required adoption date, thereby concluding that transactions between COMPANY6 and COMPANY1/COMPANY5 are to be eliminated when computing the COMPANY1 unitary business group's Illinois combined apportionment factor for the taxable year ended March 31, 2009. The regulation indicates that "such petition shall be granted in the absence of facts showing that such method will not fairly represent the extent of a person's business activity in Illinois." In this case, the elimination of such transactions will more clearly reflect the true economic consequences of sales transactions between the COMPANY1 unitary business group and its third party customers, and is consistent with Illinois' unitary business concept which treats a unitary group as a single taxpayer.

RULING

Department of Revenue Regulations Section 100.3380(a)(2) states:

The Director has determined that, in the instances described in this Section, the apportionment provisions provided in subsections (a) through (e) and (h) of IITA Section 304 do not fairly represent the extent of a person's business activity within Illinois. For tax years beginning on or after the effective date of a rulemaking amending this Section to prescribe a specific method of apportioning business income, all nonresident taxpayers are directed to apportion their business income employing that method in order to properly apportion their business income to Illinois. Taxpayers whose business activity within Illinois is not fairly represented by a method prescribed in this Section and who do not want to use that method for a tax year beginning after the effective date of the rulemaking adopting that method must file a petition under Section 100.3390 of this Part requesting permission to use an alternative method of apportionment. For tax years beginning prior to the effective date of the rulemaking adopting a method of apportioning business income, the Department will not require a taxpayer to adopt that method; provided; however, if any taxpayer has used that method for any such tax year, the taxpayer must continue to use that method that tax year. Moreover, a taxpayer may file a petition Under Section 100.3390 of this Part to use a method of apportionment prescribed in this Section for any open tax year beginning prior to the effective date of the rulemaking adopting that method, and such petition shall be granted in the absence of facts showing that such method will not fairly represent the extent of the person's business activity in Illinois.

For taxable years beginning on or after June 20, 2002, Department Regulations Section 100.3380(d)(2) provides the following special method of apportioning business income:

[W]hen the business activities of a partnership and any of its partners' business activities constitute a unitary business ... [t]he partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors. In determining the business income and apportionment factors of

the partnership, transactions between the unitary partner and the partnership shall not be eliminated.

Effective June 30, 2008, Department Regulations Section 100.3380(d)(2) was amended to provide the following special method of apportioning business income:

[E]xcept in a case in which substantially all of the interests in the partnership (other than a publicly-traded partnership under section 7704 of the Internal Revenue Code) are owned or controlled by members of the same unitary business group, when the business activities of a partnership and any of its partners' business activities constitute a unitary business ... [t]he partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors. In determining the business income of the partnership, transactions between the unitary partner (or members of its unitary business group) and the partnership shall not be eliminated. However, all transactions between the unitary business group and the partnership shall be eliminated for purposes of computing the apportionment factors of the partner and of any other member of the unitary business group.

EXAMPLE: Partner and Partnership are engaged in a unitary business. Partner owns a 20% interest in Partnership. Partnership has \$10,000,000 in sales everywhere, \$3,000,000 of which are to Partner, and \$4,000,000 in Illinois sales, \$1,000,000 of which are to Partner. In computing its apportionment factor, Partner will include \$1,400,000 from Partnership in its everywhere sales (20% of Partnership's \$10,000,000 in everywhere sales, after eliminating the \$3,000,000 in sales to Partner) and \$600,000 from Partnership in its Illinois sales (20% of Partnership's \$4,000,000 in Illinois sales, after eliminating the \$1,000,000 in sales to Partner). Also, Partner must eliminate any sales it made to Partnership.

Pursuant to Department Regulations Section 100.3380(a)(2), a taxpayer may apply the method of apportionment prescribed in 100.3380(d)(2), as amended effective June 30, 2008, to any open taxable year beginning prior to June 30, 2008, upon the filing of a petition under Regulations Section 100.3390 and absent facts showing that such method will not fairly represent the extent of the taxpayer's business activity in Illinois. In this case, there are no facts showing that the elimination of sales between COMPANY1 and COMPANY6, or sales between COMPANY6 and COMPANY5, causes a distortion of the group's business activity in Illinois. If COMPANY6 were taxed as a corporation rather than a partnership, its business income would be included in the COMPANY1 unitary business group's business income for combined apportionment purposes, sales between the COMPANY6 and other group members would be eliminated, and the group's Illinois sales factor would reflect the extent to which sales are made by the selling member of the group to third parties. Similar treatment should apply in this case. Accordingly, sales made by COMPANY1 to COMPANY6, as well as sales made by COMPANY6 to COMPANY5, shall be eliminated in computing the apportionment factor of the combined group that includes COMPANY1.

This ruling shall bind the Department for the taxable year ending March 31, 2009. The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

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Sincerely,

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